CHAPTER 5

DEMYSTIFYING CONVERTIBLE SECURITIES

"Simplicity is the ultimate sophistication."

—Leonardo da Vinci

There are a variety of fundraising strategies and associated vehicles to use for pre-seed and seed rounds of funding. You can seek traditional debt, but you will probably be required to give a personal guarantee (yikes!). You might be able to apply for a government grant or launch a presales campaign on one of the popular crowdfunding portals. You might even offer investors what's called *revenue-based funding* (RBF), in which you pay them a percentage of either revenue or profit until they've received an agreed multiple of their investment.

You could sell equity in your company, but investors rarely want the same *common* class of shares that you and the other employees were issued. They want a special class, called *preferred* shares, which come with all sorts of special rights. But during your very early days, you don't want to grant a bunch of special rights, you aren't quite prepared to set an exact valuation for your company, and you won't want to pay the high legal costs that usually accompany an equity round of funding.

None of the prior-mentioned funding vehicles are as popular as convertible securities for seed rounds of funding up to about $1 million and sometimes considerably more. That's because of their ease of use, flexibility, and low associated legal costs. Due to their popularity, you need to understand how convertible securities work, how to administer them, and when to use them to your best advantage. You should also understand the most sensitive issues from the investor's perspective.

CONVERSION BASICS

As the name suggests, convertible securities are intended to *convert* into something, and that something is equity. Most investors want equity in your company and are willing to invest now while waiting until certain conditions are suitable to actually get that equity. More specifically, they are willing to wait until they can get a preferred class of equity.

At a basic level, convertible securities are simple. They convert an investor's invested capital into preferred equity once you create and sell that class of shares to future investors in an equity round of funding. With this, investors in both the early and later rounds of funding end up with the same preferred shareholder rights. But even though the basics of convertible security mechanics are simple, the devil is in the details. Let's start with the standard terms for most forms of convertible securities.

DEFINITION: CLASSES OF STOCK

There are typically two broad classes of stock created over time. Before taking on external funding, most startups only have what is referred to as *common* stock. But later, when professional investors put money into the company, they want special rights for economic protection and an element of protectionary control. These extra rights define a new class of shares referred to as *preferred* shares. In this way, a *class* of stock denotes a group of shareholders with the same rights. Sometimes this results in multiple subclasses of shares being created to further differentiate the rights of a larger class. In other words, a company might have Series Seed Preferred, Series A-1 Preferred, and Series A-2 Preferred classes of stock, each with a different set of rights, even if only slightly different. In fact, just using the word "Series" to denote a share class almost always indicates it is a preferred class of stock.

DISCOUNT

It's not fair that the early investors get their equity at the same valuation as the future investors. After all, the money from the early investors comes at a time when the company's viability is riskier. Their early investment facilitates company growth and other valuation-driving milestones along the way to the future equity round of funding that will trigger the conversion. One way to compensate for this is to give the early investors a discount against the future valuation before calculating how much equity they will get.

A 20% discount is by far the most typical for pre-seed and seed stage funding rounds. With this, if you were to negotiate a \$5 million pre-money valuation for your future equity-based funding round, the holders of convertible securities will, instead, get equity based on a \$4 million valuation (20% discount applied to \$5 million). This means that, on a dollar-for-dollar basis, they will get more equity than the future investors, and that's absolutely fair.

VALUATION CAP

What if the investments from the early-stage investors allow the company to fly like a rocket ship and reach a future valuation of something like \$20 million when they raise their first equity-based funding round? It seems hugely unfair that the early investors convert to equity at a \$16 million valuation (assuming a 20% discount). There is no way the two parties would have been discussing such a high valuation if they had been forced to when the prior investment was made. To offset this risk and protect the early investors, most convertible securities include what's called a *valuation cap* (a.k.a. the *cap*).

Using an example of a \$4 million cap and a 20% discount, if the company is able to raise an equity round of funding from future investors at a pre-money valuation greater than \$5 million, the early investors' investments convert to equity, assuming the valuation was only \$4 million (the cap). In this way, the investors get either the discounted valuation or the valuation cap amount, whichever is more favorable to them. Using the prior-mentioned example, any future valuation less than \$5 million will result in the discount being applied (since it yields a conversion valuation less than the $4 million cap), and any future valuation higher than $5 million would result in the valuation cap being used (since all of these scenarios otherwise would yield a valuation more than the $4 million cap if the discount were applied).

Refer to figure 5.1 below to make sure you're clear on the relationship between the discount and the valuation cap. In this scenario, the convertible note has a $4 million valuation cap and a 20% discount. What you see are three different equity conversion scenarios, each with a different pre-money valuation for the equity round of funding (a Series A in this case) that causes the notes to convert to equity.

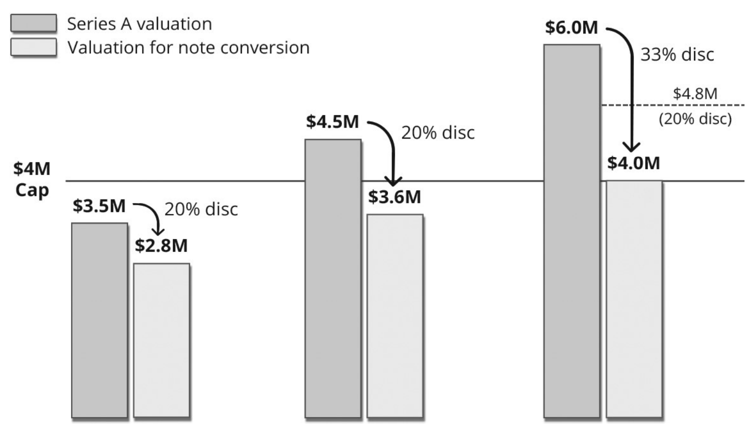

Figure 5.1. Note conversion examples

$3.5 MILLION VALUATION

Applying the 20% discount yields a $2.8 million result; since that is *below* the $4 million valuation cap, the note holders convert to equity using a $2.8 million valuation.

$4.5 MILLION VALUATION

Although the Series A valuation is higher than the cap, applying the 20% discount yields a $3.6 million result. Since that is *below* the $4 million valuation cap, the note holders convert to equity using a $3.6 million valuation.

$6.0 MILLION VALUATION

Applying the 20% discount yields a $4.8 million result; since that is *above* the $4 million valuation cap, the note holders convert to equity using the $4 million valuation.

ADDITIONAL CONSIDERATIONS

With just the information provided in these examples, we aren't able to determine the exact amount of equity the note holders will get. That is due to other factors, such as the ultimate post-money valuation when the equity round closes and other required actions that could affect the cap table with the equity round of funding.

When convertible securities convert to equity using the valuation cap, we can also calculate the *effective* discount as a benchmark. For example, using the figure above with a $4 million cap, a future equity valuation of $6 million yields an effective 33% discount for the early investors that invested using a convertible security ($4 million is 33% lower than $6 million). If, instead, the future valuation is $20 million, the effective discount jumps to 80%.

Setting the cap excessively low, even for just a subset of your pre-seed or seed investors, can cause big issues upon conversion to equity. When I say "excessively low," I mean a cap that could yield an effective discount in excess of 70%. This scenario gives the early investors such an excessive economic advantage and associated excessive amount of equity that the lead investor for the equity round of funding might not be able to reach their required equity target. That can be a deal killer. But it also depends on how much investment, in total, converts at an excessively high discount. A single investor in a very early round with only a $25,000 investment might not cause a big problem. But a full $500,000 seed round at that level will surely cause a problem.

It is not required to include a valuation cap with your convertible security. Experienced investors will definitely take note if you don't, and it might prevent them from investing. But if your investment opportunity is highly sought after, you might be able to get away with what's called an *uncapped* convertible security. Just know that it's extremely rare.

EARLY EXIT MULTIPLE

What if the company skyrockets and ends up being acquired for a decent amount of money before ever needing to raise an equity round of funding that would cause the conversion? It seems unfair that the early investors only get their initial investment back. In order to reward the early investors, many convertible securities have rights related to such a change-of-control event that call for the investor to get some multiple of their invested capital.

DEFINITION: CHANGE OF CONTROL

An activity that causes a change of company ownership is considered a change of control. An outright acquisition is the most familiar form, but other actions that significantly affect the balance of equity ownership can also be considered a change of control, depending on the definition included in the legal document.

A 2X multiple is fairly common for this, and it allows the early investors to double their invested amount. Some convertible securities also give the investor an option to instead convert to equity using the stated valuation cap as the valuation. If that gives them a better return than the exit multiple, they can participate in the acquisition as an equity holder with others.

SIMULATING FUTURE CONVERSION

Due to the interaction of various terms included with both the early-stage convertible security and the future equity round of funding that causes their conversion, it's difficult to predict what the future cap table will look like after conversions. That means it's also hard to explain to a casual, early-stage investor how much equity they might end up with in the future. The good news is there are plenty of online cap table simulators (including one on the resources page of my website) to help you run various scenarios and eliminate the guesswork.

CONVERTIBLE NOTES

The most popular form of convertible security for early-stage startup funding is the convertible note (a.k.a. "note"). As the word *note* suggests, it is a form of debt (a loan). But instead of making regular payments to pay off the debt, the principal amount of the note plus accrued interest over time converts to equity when an equity round of funding is raised and using the mechanics previously described. And since convertible notes are a form of debt, they include a couple of unique terms.

TERM (MATURITY DATE)

Just like a car loan or a home mortgage, convertible notes have a stated term and associated maturity date (the end of the term). If you reach the maturity date without a natural conversion to equity, the note holder could technically call for you to immediately pay back their principal amount plus accrued interest. This is referred to as *calling the note*. But since that would likely kill an early-stage company, there are usually some other options.

Upon approaching the end of the term, it's not unusual for a startup to ask for an extension to the maturity date. Some convertible notes even give the early investor an option to convert to common class equity if the maturity date is reached. They do so by using the valuation cap or a discounted version of the valuation cap to determine how much equity they get. I find that, as long as a reasonable valuation cap is in place to protect the investor, and as long as the company still has decent odds of raising an equity round of funding, most investors are OK to grant an extension to the maturity date. They will continue to accrue interest and are still hoping to get a preferred class of stock for their investment.

Make sure to give yourself enough time via the stated term when using a convertible note. A term of 18 to 24 months is typical for a seed round, and 36 months shouldn't be frowned upon for a pre-seed round. You basically need enough time to safely reach an equity round of funding in which you sell a preferred class of shares to future investors.

INTEREST RATE

Like any form of debt, convertible notes carry an interest rate. The interest accrues until either an equity conversion takes place or the note is paid off. For the conversion to equity, the amount of accrued interest is added to the investment principal before calculating how much equity the investor gets. In other words, a $50,000 note investment might later convert to equity at a total value in the $53,000 to $58,000 range, depending on the interest rate and how much time goes by before conversion.

Early investors aren't investing just to earn interest on their investment. But that doesn't mean they won't notice a ridiculously low interest rate. Most of the notes I see offer an interest rate in the 6% to 8% range. If you stick within that range, you probably won't get any pushback from investors.

QUALIFIED FINANCING (A.K.A. QUALIFYING TRANSACTION)

Most convertible notes don't convert to equity unless the future equity round of funding reaches a stated minimum size. A term commonly called *qualified financing* defines this minimum amount. A typical qualified financing amount is two to three times the target size of the pre-seed or seed funding round. Technically speaking, if a future equity round of funding does not reach the minimum threshold, the note holders aren't entitled to an equity conversion.

COMPARING THE SAFE TO CONVERTIBLE NOTES

Initially made available by a world-renowned startup accelerator called Y Combinator (YC) in 2013, and subsequently updated in late 2018, the SAFE is a convertible security that was created to serve as an alternative to the highly popular convertible note. SAFE stands for *simple agreement for future equity*, and it is prevalent in California. Since its introduction, its use has spread throughout the country. At the time of this writing, SAFEs probably represent 20%

of early-stage investment rounds outside of California among those using convertible securities.

A SAFE is a short investment document that has been open-sourced and is intended to be simple to understand and convenient to administer. It's not a debt instrument, and that's mostly what makes it different from a convertible note. SAFEs don't have a maturity date or a stated interest rate. You can see a side-by-side comparison of the SAFE and convertible notes in figure 5.2 below.

Attribute	SAFE	C-Note
Convertible Security	✔	✔
Discount	✔	✔
Valuation Cap	✔	✔
SEC Characterization	like a warrant	debt
Future Conversion	post-money	pre-money
Term (Maturity Date)		✔
Interest Rate		✔

Figure 5.2. Comparing SAFE to convertible notes

Until the 2018 SAFE template updates by YC, I wouldn't have disqualified a personal investment opportunity that uses a SAFE, and I wouldn't push hard on a startup I advise to switch from a SAFE to a convertible note. However, with the 2018 update, I have a different opinion, and it relates to the switch from a pre-money to a post-money calculation for future equity conversion. Without getting into the technical details, this change alone makes the SAFE much less founder friendly if they are used for multiple rounds of funding before an eventual conversion to equity. That is because it gives a big antidilution feature to the investors versus convertible notes. The holders of common stock (i.e., founders, employees, advisors) take the extra dilution hit upon the SAFE's conversion to equity, assuming the post-money version of the SAFE is used.

I also predict some misunderstanding and perception issues related to the higher amount needed for a post-money valuation cap. For example, a convertible note with a $6 million valuation cap (pre-money) might yield the investor the same post-conversion equity as a SAFE with an $8 million valuation cap (post-money). But investors might initially perceive the SAFE's valuation cap as overpriced just by looking at the numbers and comparing across multiple investment opportunities.

The new post-money SAFE template does bring more clarity to early investors regarding the likely equity they will get in the future, but this seems to be at the risk of extra dilution for common stockholders. If you choose to use the post-money version of the SAFE, discuss this with your attorney and model various scenarios using a cap table simulator—more specifically, one that can accommodate convertible securities that convert to equity based on a post-money valuation cap.

The lack of a maturity date on the SAFE is worth noting. That's because there is a possibility that it never converts to equity, and there's also nothing in the terms that calls for the investment to be repaid to the investor. This is the most typical concern I hear from investors about the SAFE. With a convertible note, approaching the maturity date forces a conversation between the company and the investor. With a SAFE, the startup could evolve into a small—but profitable—lifestyle business that pays the founders a handsome salary but never reaches the point of being able to exit via acquisition. Any investor with a SAFE could end up getting stuck with no path to an investment return—and no recourse, either.

SAFEs don't convey an interest rate. But since investors aren't overly excited with making 6%–8% on their investment while waiting for it to convert to equity, I don't find the lack of an interest rate as a major inhibitor.

Since SAFEs are not considered securitized debt, if things don't work out and you have to liquidate the company, SAFE investors might be further down the list to get any entitled distributions from the assets you liquidate. Convertible note holders sit higher in the pecking order, and this might also be on the mind of your early investors, especially those that have had seed-stage investments crash and burn.

The way the SAFE documents are written, any size of preferred equity round of funding will cause the SAFE investment to convert to equity. This is compared to most convertible notes that require the future equity round of funding to reach or exceed the minimum size required to be considered a qualified financing.

If your company is established as a limited liability company (LLC) and you prefer to use the SAFE for your early-stage funding rounds, check with your attorney first to make sure it is possible. There are conflicting opinions on this, and alterations to the template might be required.

HOW TO CHOOSE?

I believe it would be a fair assessment to conclude that the original pre-money SAFE is slightly favorable to the startup, the newer post-money SAFE is very favorable to the investor, and convertible notes are slightly favorable to the investor. But that's not the only factor to take into consideration when deciding which form of convertible security to use. You must also take familiarity into consideration.

I mentioned that, at the time of this writing, probably only 20% of early-stage investments outside of California use SAFEs. That means that casual angel investors in your city or region might have never seen one. If they've never used it before, they might not be willing to take the time to educate themselves on the differences, and they certainly might not be willing to pay their personal attorney to review it and explain it to them. Saying that "it's just like a convertible note but without a maturity date or interest rate" would be mostly true, but possibly not enough to overcome the concern.

A seed round of $500,000 or more can easily involve 15 to 20 individual angel investors. If 30% of the angels in your local market aren't comfortable using the SAFE, you're adding headwind to your funding round. Because of this risk, if you want to use the SAFE, during the phases of your fundraising campaign in which you're determining investor interest and later getting more specific with them and prioritizing accordingly, try to gauge each investor's familiarity with SAFEs and their willingness to invest using them.

EXTREME FLEXIBILITY

Convertible securities are unbelievably flexible. Although they are commonly used to support a pre-seed or seed round of funding, the agreement is directly between an individual investor and the company. Technically speaking, each investor could be presented with different terms. Doing so would create an administrative mess for the startup, especially when trying to figure out the equity conversion mechanics. But it can be done, and it presents some interesting advantages and opportunities.

One such advantage is referred to as a *rolling close*. As each investor commits by signing the convertible security, they can transfer their funds and you can immediately put them to work. Equity rounds of funding usually have one or more official close dates with minimum threshold amounts for being able to get your hands on the funds.

The rolling close is a double-edged sword. On one hand, being able to gain possession of funding as the commitments are made allows you to immediately put the increments of new capital to work. On the other hand, if the commitments are spread out over several months, it can create a hand-to-mouth scenario that never lets the company really make the intended investments and commitments. Because of this, I strongly recommend only increasing expenditures based on actual investments received and not based on the target amount for the funding round.

BRIDGING A GAP USING CONVERTIBLE SECURITIES

Most startups think of convertible securities only in the context of a pre-seed or seed round of funding. What they don't know is that these instruments are ideal for a bridge round to close a needed gap to the next logical round of funding. It is important to understand the differences and nuances when using convertible securities for this purpose.

Previously, we reviewed the difference between wanting and needing to raise money. Bridge rounds can be associated with each case. You might be running low on cash and *need* to raise money to reach the sweet spot investor criteria for the next round of funding. Conversely, you might have a big outcome on the near-term horizon and *want* to raise money so that you can safely accomplish that outcome to get an associated bump up in valuation before you start your fundraising campaign. In either case, a bridge round is specifically used to buy enough time to bridge the needed gap.

THE BENEFITS OF USING A CONVERTIBLE SECURITY

For the same reasons convertible securities are so popular for pre-seed and seed rounds of funding, they are also ideal for bridge rounds. You aren't forced to set a valuation for the company, you get the advantage of a rolling close, and legal costs and associated efforts are fairly minimal. But since this is a short-term bridge intended to just buy a little extra time, there are typically some differences from using a convertible security for a seed round.

TERM

If you're using a convertible note, the term should be short. In fact, if the note doesn't have a short term, then it doesn't support the messaging of it being used to bridge a gap. Something in the range of six months is typical, and anything close to one year starts to smell like another regular round of funding rather than a bridge. For this reason, using a SAFE for a bridge round might be more difficult to sell to investors. It doesn't have a term or maturity date.

DISCOUNT

With such a short expected lifespan, a bridge round can come with a lower discount than a full seed round of funding. Whereas 20% is a typical discount for a regular round, a 10% discount is more typical for bridge rounds. This makes sense if you associate the planned runway with the discount offered. The shorter the runway, the lower the discount.

Some investors might worry that you will open up another bridge round due to difficulty in raising the intended equity round of funding. To offset this risk, you can offer a *staggered discount*. If the convertible security converts within six months, the investor gets a 10% discount, and if it takes longer than that, they get a 20% discount.

VALUATION CAP

For bridge rounds, it's more practical than for regular rounds of funding to not have a cap, especially if you fit into the "want extra time" category instead of "need extra time." Remember, the valuation cap is intended to offer the investor a high-side valuation protection mechanism. With a short term like six months, the odds are very low that you're going to suddenly and surprisingly grow like a rocket ship. Just know that if you end up needing to ask for an extension to the maturity date, the investor is going to want to put a cap in place to protect them.

SUMMARIZING STARTUP SUCCESS

The various stages of funding can be fulfilled with a variety of funding sources, each with a corresponding legal investment instrument. The factors that make for a logical and ideal combination of source and instrument include the stage of the company, the amount to be raised, and the personal goals and preferences of the company executives. For technology startups in the pre-seed or seed stage, convertible securities are the most popular instrument when raising small amounts ($1 million or less) from friends and family or angel investors. They are also popular for bridge rounds between almost any consecutive stages.

A key reason convertible securities are so popular for these situations is their extreme level of flexibility and ease of use. Technically speaking, each investor in a given round of funding could be presented a convertible security with different terms. That is certainly not advisable because of the administrative nightmare and likely perception of unfairness among the investors, should they find out; but it does attest to the extreme level of flexibility that is offered. In fact, even the concept of a *funding round* is not nearly as rigid when convertible securities are used. The rolling close nature of funding rounds that utilize convertible securities means that with each closed investor, new cash hits the bank account and can immediately be put to use. This hand-to-mouth aspect of the rolling close can also be distracting and disjointing if a funding round stretches out over a long period of time. That's because the company can't really shift a gear like intended, but rather has to take incremental steps along the way, just in case the full target amount isn't reached.

The ease-of-use aspect of convertible securities translates to lower legal costs. Once a term sheet and funding document are papered up by your corporate attorney, you will be able to make any needed tweaks for specific investors and do most of the work with minimal involvement from your attorney.

Although a convertible security is both flexible and easy to use, that doesn't mean the various terms that need to be set are simple or unimportant. The terms really matter and must be set with care. For example, as was described, setting the valuation cap way too low could have serious negative implications to your future equity round of funding. But used effectively, a convertible security with the right terms will enable you to close your funding round as quickly as possible so that you can get off the fundraising trail and get your head 100% back into growing a great business.

AHA MOMENTS

1. Convertible securities allow an investor's investment to convert to equity in the future once their more desired preferred class of stock is available.
2. The discount and valuation cap serve as the investor's primary economic benefit versus the valuation offered to the future equity investors.
3. The valuation cap is not intended to set an exact valuation for the company at the time the funding is raised. Instead, it is intended to serve as a protection mechanism for the investor in the event the company grows more aggressively than expected and is able to earn a valuation that is considerably higher than expected. However, investors will comprehend the possibility of converting to equity using the cap amount, which means it must be perceived as *reasonable*.
4. For future equity conversion, the holder of a convertible security gets either the discounted valuation or the valuation cap amount, whichever is more favorable to them.
5. The SAFE is not considered a debt instrument like a convertible note is. As a result, it does not have a maturity date (term) or interest rate. The lack of a maturity date might cause an investor to consider it less investor friendly, because there is no forcing function in the future for converting to equity or paying back their investment.
6. If using a SAFE, decide whether you want to use the original version with a pre-money valuation cap or the newer post-money version. The conversion mechanics are different.

7. Since a convertible note is considered a debt instrument, investors might stand in a more favorable payback priority position if the company is liquidated or sold in distress.

8. When convertible securities are used to support a bridge round, the term is usually short, and the discount is often lower than when used for a traditional round of funding.