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Start up financing: play it SAFE, or take notes?

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If you want to make your business dream a reality your company probably needs to raise or borrow money. Your family, friends, and close business associates are likely the first people you will ask to invest in your business. Except for maybe your parents, investors are not going to simply donate money to you for nothing in return: you will need to either promise to repay them (a debt) or make them part owners of your company (equity).

There are pros and cons with each option, but most early-stage investors will prefer to receive equity over debt. A loan does not offer the lender any chance to share in the future profits of a successful company: the lender only stands to earn, at a maximum, its principal amount loaned plus the agreed-upon interest. Yet the lender shoulders the same risk as an early stage equity investor, because it is most likely that the start-up company will fail and therefore not repay the loan. Investors want the ability to share in the upside if the company succeeds, and therefore it is most common for investors to want equity in return for their investment.

Full-scale equity financings can be very costly. At later stages in a company's development it may make sense to undertake a full equity financing, which involves valuing the company and issuing shares to the investors, usually involving multiple investors (such as venture capital or private equity firms), law firms, accounting firms, and more. The transaction costs can be relatively high, making this option too burdensome for smaller investments. However, for an early stage investment from friends and family there are simpler, less costly ways to conduct the transaction.

Two common methods of investing in early-stage companies are convertible notes and Simple Agreements for Future Equity (SAFEs).

A convertible note is similar to a traditional loan, except it grants the lender the option to convert the debt owed to it into equity. The note will carry an interest rate and have a maturity date. When the note matures, the company must either pay back the loan or convert the principle to equity, usually at the investor's discretion. A convertible note provides more protection for the investor, but it can be a burden for the company if a significant amount of loans must be paid out simultaneously.

SAFEs are designed to be a simple and cost-effective way to invest in an early-stage company. The agreement is structured so that an investor provides cash up front but is not issued equity until later in the company's life, upon the occurrence of a "qualifying event," usually defined as a large equity financing. When the qualifying event occurs the SAFE is converted and the investor is issued shares in the company. SAFEs provide the company the benefit of not having to worry about a maturity date and having to pay back a loan plus interest. The investor, however, shoulders some risk that the company will never achieve a large financing and therefore the SAFE would never convert.

Both SAFEs and convertible notes are useful options for financing an early-stage company, but which choice is right for your company will require a consideration of many other factors such as the appropriate prospectus exemption, industry, investment climate, number of shareholders, and more.

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