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Making a SAFE Bet Safer: Five Factors to Consider Before Signing Your Next SAFE Note

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Some startup investors might think the biggest innovation to come out of Y Combinator in 2013 was DoorDash — particularly those investors who took part in the company's early funding rounds and walked away with impressive returns on their investments. But for most startup investors, the biggest innovation Y Combinator gave the world that year was the "simple agreement for future equity" or SAFE.

SAFEs, like convertible debt, provide a means to incentivize early investors to de-risk an emerging business by offering them a way to buy into the issuer's next equity financing at a discount. SAFEs are not debt, however, and do not have a maturity date or an interest rate, which limits some of the levers investors can pull in the event that the startup goes sideways.

While SAFEs can benefit investors by reducing transaction costs and legal fees, they can spell trouble for two main reasons. First, they provide no guarantee that the investment will turn into equity, as it is possible that a startup never hits the conversion triggers outlined in the SAFE, such as the sale of stock in a future priced round or a sale of the company, leaving SAFE investors with little to no recourse if the conversion events are not met. Second, SAFEs are rarely negotiated, and the process for amending them when circumstances change for the issuing company can be practically difficult.

For these reasons, SAFEs can be risky for investors, particularly when investing early in a company having difficulty achieving the hockey stick growth that would usher in future priced rounds at exponentially higher valuations, a sale, or an initial public offering. At the other end of the spectrum, it is possible for a startup to do exceptionally well in the marketplace without engaging in activities that would trigger an equity conversion, leaving SAFE holders with an economic position but without any of the voting rights associated with equity ownership. Because of these risks, when the investors' only opportunity to invest early in an attractive startup is through a SAFE, they will need to carefully vet the startup to determine if they can minimize the risk they're taking by investing in it. With the caveat that investors will never eliminate all the risk they face when they invest in an early-stage startup through a SAFE, examining the following five factors can help investors determine whether they're making a safer bet.

What is the nature of the startup's products or services, and what industry is it in?

The best place to start this analysis is with the most obvious question: What does the startup do, and what industry is it in? It is vital to determine whether the company is in an industry where a conversion event and ultimate favorable outcome is not only possible, but also likely under current market conditions.

How is the startup's leadership team?

Some investors claim they don't invest in companies, they invest in founders. Even if investors do not subscribe to that belief, they need to evaluate the founder(s) and leadership team of the company they're contemplating investing in through a SAFE.

Has the leadership team had multiple financing rounds or profitable exits in the past, and does it know the game plan for pulling those off again? If not, has the team worked for founders and companies that have done so, and could be in a position to replicate those strategies and tactics?

How strong is the leadership team's vision for the company and its work ethic? What does the leadership team's education, work history, and hobbies and interests say about the leaders and their abilities to grow a company? Do they show signs they will do everything in their power to win the startup game? Or do they have a laid-back approach to business that suggests they're not motivated to build the company to a size that would provide opportunities for a conversion event for its investors who signed SAFEs?

Who are the other investors in the company, if any?

The Y Combinator form of SAFE is a standalone document that does not require the issuing company to identify whether there are other investors or the amount that other investors have invested. SAFE investors should confirm the amount that other investors have invested to avoid investing in an undercapitalized business.

Of course, if there aren't any other investors, that raises additional questions. Are there none because other investors either did not want to invest through a SAFE or had reservations about investing in the startup generally? In this scenario, investors should consider requiring the company to meet a certain aggregate investment threshold before committing their money through a SAFE.

Have there been earlier rounds of investments or other signed SAFEs?

While SAFEs are typically used early in a startup's life, investors might have the opportunity to enter into a SAFE after multiple rounds of financing have occurred. If this is the case, investors should determine what those earlier rounds of financing say about the startup's past and future.

Are the earlier rounds a sign the startup has burned through cash too quickly, with too little revenue, to continue to operate without an infusion of desperately needed cash? Or do those rounds show a belief by investors in the startup's leadership team and mission?

Have the earlier financing rounds been through SAFEs as well or through more traditional means of capital raising? If they've been through the latter, why are the investors being offered a SAFE now?

Are the would-be investors qualified to evaluate these factors?

Finally, faced with the potential to enter into a SAFE with a startup, would-be investors need to determine whether they and/or their colleagues are even qualified to properly vet the startup. Some companies want to dabble in startup investing, but their “scout” teams are not familiar with the process and wouldn’t know what to look for. Even when they know what to look for, would those teams be able to find answers? Can they ask the right questions about a startup’s offering, industry, and leadership team? Can they suss out the economic and market conditions likely to affect the startup? Do they know how to track down earlier investments and other investors in the startup? In other words, can would-be investors do the due diligence necessary to determine whether they should invest in a startup through a SAFE?

If the answer to these questions is “no,” but the investment opportunity seems promising, it’s not time to give up — it’s time to call in help!

Make a SAFE bet safer

All investments carry risk for investors making those investments, and while SAFEs can be documented and negotiated quickly, they are not without risk. Because SAFEs have become one of the predominant forms of early financing vehicles for startups of fundraising over the last decade, they will be inescapable for investors interested in the startup space. Though no investment is truly without risk, by evaluating the above five factors as part of their due diligence into investing in a startup through a SAFE, would-be investors might make their SAFE bet a bit safer.

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