Startup Financing Strategy During COVID-19

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In the VC community, especially for early stage investments, the valuation of a startup is strongly influenced by subjective factors, mainly how the investors view the business, market and management team of the startup. While there are no objective benchmarks for valuing early startups, the valuations of these companies are especially vulnerable to an uncertain economy.

Valuation is a very important issue for startups. If the valuation of the company is too high, then there will likely be a down-round[1] in the next equity financing of the startups. If the valuation is too low, then the startups will give away too much of their company for the amount of capital they raise. The uncertainty surrounding the future impact of COVID-19 on our economy is making it much more difficult for both investors and startups to assess the valuation of early stage companies.

What can a startup do to obtain funds and reduce the risk of a next down-round equity financing during such uncertain market circumstances? The Simple Agreement for Future Equity (“SAFE”) approach could be a good choice to cope with the uncertainty in the market.

The SAFE structure was created by Y-Combinator as an easy-and-quick standard agreement for startups to raise money at an early stage. The SAFE forms have evolved over time, but the guiding principles behind SAFEs have remained intact: SAFEs provide investors and founders a means of allowing a startup to raise equity capital without setting a valuation during a period of uncertainty while at the same time giving investors and founders a high degree of certainty around the level of ownership associated with a SAFE investment. The SAFE approach to financing has many advantages, but investors and founders need to fully understand the SAFE structure and its potential disadvantages before taking this route.

Advantages

SAFEs would be a good strategy to raise money in the current uncertain economic climate due to the following advantages:

1. SAFEs avoid the immediate need to set the valuation of the company because the startups and the investors only need to fix a valuation cap[2] in the SAFE instrument and allow the valuation to be determined in a later round that would typically be led by a VC fund. This could help to avoid a down-round in the next equity financing.

2. SAFEs, in their simplest form, are standard agreements. The standardization and simplicity help startups save legal fees and negotiation time, thus lower the costs and increases the speed with which startups will receive financing.

3. SAFEs are easy to understand and their standardized format may help startups to attract smaller investors.

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4. As compared to convertible notes, SAFEs have no interest rate and no maturity dates, which saves startups money and reduces the time pressure on them to raise an equity round.

Disadvantages

However, SAFEs also have some disadvantages.

1. SAFE financing rounds usually raise relatively smaller amounts of capital than a formal equity round.

2. If a startup uses multiple SAFE rounds in a row, the result can be a more complex cap table. This is especially the case when a startup issues numerous SAFEs in very small amounts, which will create a very complex cap table and can potentially create significant and unexpected dilution for an unsophisticated founder.

3. SAFEs attract smaller, non-institutional investors. Hence, unless the startup is being advised by experienced angel investors or part of a well-developed incubator, a startup raising money using a SAFE may not be able to get the expert business guidance they would have received from institutional VC investors.

Conclusion

SAFEs are an easy, quick and relatively low cost way to raise money when the market is uncertain. They allow a startup and investors to focus on financing the company without focusing excessively on the risks associated with setting a valuation that is too high or too low in a volatile market environment. Overall, SAFEs are a good fund-raising strategy which can allow a startup to quickly receive financing are and help it survive this challenging economy.

[1.] “Down round” equity financing means the company values less than the previous round of equity financing, i.e. the price of the shares of the company in the current financing is lower than the price of the shares sold previously.

[2.] “Valuation cap” means a ceiling, or cap, on the pre-money valuation at which the SAFE swill convert in a next equity financing. If the startup’s valuation in the next financing is greater than the valuation cap, the SAFE investor’s money will convert at the valuation cap.

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