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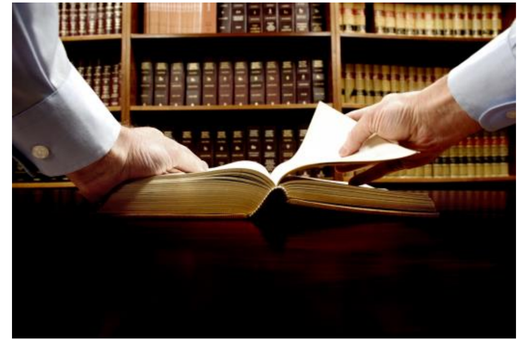

SAFEs-Start-up Company Financing

By Shahram Safai, Silvia Pretorius and Mohammad Nawash

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The UAE has seen a significant increase in investments and entrepreneurship over the last decade. The Dubai International Finance Centre (DIFC) reported record growth driven by '*a robust ecosystem, global partnerships and investment in FinTech and Innovation*'. This exceptional growth in investments has acted as a catalyst for the increased usage of Simple Agreements for Future Equity (SAFEs) in start-up company financings.

SAFEs are a method of funding directly between start-ups and investors used in the seed financing rounds of a company's start-up phase to raise capital in return for future equity. They have been an increasingly popular form of funding within the start-up ecosystem since their establishment in 2013, and even more so since their modification in 2018.

What is a SAFE?

SAFEs were established to create a quick and easy way for investors to invest in start-ups using a simplistic legal document that is entrepreneur friendly and easily understandable. Under a SAFE, investors can provide funding for start-up companies during the initial phase of funding of a company and in return, the SAFE will convert into ownership of shares during the next equity investment round of funding at a predetermined rate. The major difference between SAFEs and other forms of start-up financing such as convertible notes, is that SAFEs have no interest rate or maturity date.

Pre-money SAFEs vs Post-money SAFEs

When introduced in 2013, SAFEs were formed based on pre-money valuations which are based on the initial value of the company before taking into account the investment contributions made by the SAFE investors (pre-money SAFEs), however, complications resulted as SAFEs became increasingly popular and of higher value making it difficult for start-ups to know their share capital dilution and for investors to know their relative ownership percentage. In light of this difficulty, SAFEs were revised and adapted in 2018

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(post-money SAFEs).

The key difference between pre and post money SAFEs is that the investor's ownership percentage using a post money SAFE is fixed and calculated based on a fixed post SAFE valuation. This makes it much more transparent and guarantees the investor a minimum percentage of ownership after the SAFE round.

Pro Rata Rights

Initially, pro rata rights were compulsory in SAFEs meaning SAFE holders were required to participate in subsequent equity rounds in order to maintain their percentage of ownership without dilution. However, upon adaptation in 2018, this was changed and pro rata rights became optional for investors.

Advantages and Disadvantages of SAFEs

The advantages and disadvantages of SAFEs are:

Advantages

- No interest rates (unlike convertible notes) meaning the costs of financing are lower.
- No maturity date which means theoretically the SAFE could be everlasting, except in the following circumstances, which would terminate a SAFE: the following equity round, acquisition of the business, IPO or if the company shuts down.
- Instant transactions directly between the start-up and the investor meaning no co-ordination with other shareholders is needed.
- Simplicity makes it a cost effective and time effective option.

Disadvantages

The disadvantages of SAFEs are dependent on the type of SAFE acquired.

- The disadvantages of a pre-money SAFE is that it lacks transparency between the start-up company and investor as tracking dilution and stock ownership is difficult.
- The most significant drawback of pre-money and post-money SAFEs is the inevitable dilution effect on existing investors, which is amplified even more in post-money SAFEs because a guaranteed minimum percentage of ownership is given to investors.

Conclusion

SAFEs have proven to be an increasingly popular method of start-up company financing, and we anticipate this trend to continue, especially in the Middle East. The upcoming EXPO 2020, beginning

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in October 2021, which aims to attract more investors into the Middle East will further accelerate the growth of the start-up/venture capital ecosystem and the use of SAFEs. In addition, the successful handling by the UAE government of the COVID-19 crisis continues to bolster the attraction of the UAE as an investment destination. ■

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Afridi & Angell

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