Startups: Don’t Waste Your Time Pitching Without a Valuation Cap

Why I will not invest in an Uncapped Note or SAFE

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What’s Today’s Discount on Your Convertible Note? Photo by Artem Beliaikin on Unsplash

Over the past couple of weeks, I’ve been pitched by a large number of promising startups offering unacceptable terms. After convincing me they have an important new product with a great opportunity and a killer team, we get to the financing.

The deal terms are a convertible note or a SAFE with a 20% discount and no valuation cap. I let out a big groan. I just wasted an hour. I sure hope these uncapped deals I’m being pitched recently are a coincidence and not a trend.

I will not invest in an uncapped note or SAFE. Please consider offering a reasonable valuation cap. If you don’t know what valuation cap to use, I’m happy to work with you on that. But don’t waste your time pitching me on an uncapped note or SAFE.

What Is an Uncapped Note?

A convertible note is legally a loan, with the full amount converted to preferred shares when the startup raises its Series A round. (See my previous article for a detailed explanation of convertible notes and SAFEs.)

As a loan, the convertible note has a maturity date prior, typically 18–24 months, by which time the startup must raise the Series A round, or at least in theory, is on the hook for repayment. (Since repayment is impossible, an extension is almost always negotiated.)

A SAFE is similar: the investor pays her money now and gets stock when the Series A is raised. Unlike a convertible note, the SAFE has no maturity date or deadline, so Series A could be years away.

Both the convertible note and SAFE have 3 options for offering an investor an incentive to invest at an earlier, risky stage:

- valuation cap
- discount
- most favored nation (MFN)

Without a valuation cap or discount, my early investment is converted to equity at the same price as the Series A investors. My only reward for investing before the big boys is that I'm being allowed to invest at all. If Elon Musk offers me this deal, I might consider it. Anyone else, no thank you.

The valuation cap is a limit on the price I pay for the shares. When my investment is converted to stock, I get the same price as the Series A investors up to the limit of the cap. If the cap is $10M and Series A is priced at $20M, I purchase my stock at the $10M valuation. If Series A is priced at $5M, I get the stock at the $5M valuation.

A discount means I pay the same price per share as the Series A investors minus a percent discount, kind of like a Bed Bath & Beyond coupon. A typical discount is 20%. If my SAFE includes a 20% discount and the Series A valuation is $10M, I buy my shares at $8M.

MFN means I get the lowest price per share any investor has negotiated. If investor 1 has a $5M cap, investor 2 has a 20% discount, and the Series A valuation is $10M, if I have a MFN clause, I get a price per share based on the $5M cap.

These terms are not exclusive. A convertible note typically has both a valuation cap and a discount, and sometimes an MFN clause, too.

What's Wrong With an Uncapped Note?

An *uncapped note* or SAFE is any option that doesn't include a valuation cap. For early-stage investors, this is a horrible choice.

At the pre-seed stage where I usually invest, let's say a startup I'm considering has a valuation of somewhere in the $10M range.

In the 18 months from when I invested in the SAFE until VCs are interested in a Series A round, the product has gone from basic MVP to generating significant revenue. The valuation should jump to something like $20M or possibly higher.

Strictly from a financial perspective, a 20% discount off the Series A price for investing at an earlier stage is hardly a good deal.

Worse, a year later, instead of raising a Series A that would convert my investment at the $20 million valuation, the startup decides to raise another round of convertible notes. Now I'm really screwed. Because another 12 months later, if the company has hit its milestones, the valuation might reach $50M. Even with the discount, I'm paying $40M for a stock that was worth $10M when I bought it. As an investment, that makes absolutely no sense at all.

The one situation where this might conceivably make sense is if the startup is already far along in the process of negotiating the Series A and needs a little cash to tide it over until the deal is done. In other words, 20% might be a fair discount for a 3-month period.

But even in this situation, it puts the risk on me that the startup successfully completes the Series A raise. And if it raises enough money on this "temporary" bridge note instead, it might decide to postpone the Series A for a year or two, leaving me holding the bag.

So even in this situation, I insist on a valuation cap. In fact, in this case setting the cap is easy since it can be a 20% discount from the valuation being offered to Series A investors.

Founders have argued that if the company will be worth $20M in 18 months and $50M in 36 months, why not accept a 20% discount from the $20M valuation now? After all, if someone offered me the right to purchase Apple stock at 20% off its valuation in 18 months, I might consider it.

However, that misses the entire point of valuations in early-stage startups. The valuation is $10M now and $20M in 18 months because with only an MVP and a skeleton team, the company has twice the risk of failure as it will after hitting 18 months of milestones and building customers. Apple has essentially zero chance of failing in the next 18 months.

Despite all the pretty slides on the deck and the wonderful promises of world-changing success, I estimate the odds that even the most promising startups will hit their revenue projections at about 1 in 25 at best. If you do, congratulations! Your startup deserves the higher valuation at that time. But most startups will struggle, and many will fail. The valuation is much lower now reflecting the higher risk.

So if you're pitching me, either offer me a set price for preferred shares, or a convertible note or SAFE with a valuation cap. Without a cap I'm not investing, so don't waste your time pitching.

Note: to keep the explanation simple, I've ignored the difference between pre-money and post-money valuations. Convertible notes are based on pre-money valuation. SAFEs are now based on post-money valuation. If the startup has raised a large amount in early rounds, the difference between pre-money and post-money valuations can make a huge difference in the price actually paid for the stock.