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Post-Money Convertible Financing: Slowing Down Convertible Merry-Go-Rounds

Some time back, I wrote a piece decrying the misuse of convertible debt/equity financing structures in early stage financings. Too many entrepreneurs – aided and abetted by too many naïve or lazy investors – use *ad hoc* convertible bridges for no discernable purpose beyond keeping the lights burning. Bridges to nowhere, so to speak. Perhaps less egregious, but equally problematic, entrepreneurs dress up convertible "rounds" as substitutes for priced rounds – in the process creating opaque cap tables that short-circuit future equity rounds.

Today, a look at a newish tool for investors who would like to put a stop to convertible debt merry-go-rounds. Or at least slow them down before they get taken for too long a ride.

The tool is the Post-Money SAFE, a transaction structure served up in 2018 by Y Combinator (the creator of the traditional – now the "Pre-Money" – SAFE). The SAFE is an equity-based alternative to traditional convertible debt financing structures. For purposes of this blog, I'll generalize the analysis as Pre- and Post-Money Convertibles, as the key concepts under review can be addressed with more or less equal aplomb in both equity- and debt-based convertible structures. (I'm also going to assume there is no conversion discount: simplifies the math.)

A foundational point: The Pre-/Post- difference only matters when there is a cap on the conversion valuation. Don't get distracted by the Pre-/Post- distinction unless there is a valuation cap in the applicable Convertible transaction (or somewhere in a series of Convertible transactions).

The Basics

The essential difference between the Pre- and Post-Money Convertible is that the Pre-Money structure caps the *pre-*money valuation of the conversion triggering financing round, while the Post-Money structure caps the *post*-money

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valuation of the trigger round. That's it. (While the Y Combinator folks took the occasion of introducing the Post-Money template to make a bunch of other changes to their SAFE form document, the Post-Money feature is the headline news.)

The distinction between capping pre-money valuation and capping post-money valuation may seem small, but it is a very big deal. *The Post-Money Convertible investor locks in a minimum post-trigger financing ownership percentage regardless of whether and how much additional equity – including additional Convertible equity – is issued before or in the trigger financing*.

Consider a simple example. Investor A buys a $1 million *Post*-Money Convertible with a $4 million valuation cap from Newco. *Because the cap is post-money, the size of the equity pie post the trigger financing is capped at $4 million.* Thus Investor A has locked in a minimum 25% ownership stake ($1 million of the $4 million post money cap) in Newco at the close of the trigger financing.

What happens if after Investor A's purchase, Investor C comes in with $1 million of new money at the trigger financing? Investors A and C will each have a 25% equity stake at the closing of the trigger ($1 million each of the $4 million post money cap), leaving 50% for everyone else. Suppose Investor B comes in with a second $1 million Convertible before the $1 million trigger. Now, Investors A, B and C each own 25% post the close of the trigger, with just 25% left for everyone else.

Now flip the hypothetical so that Investor A kicks things off with the purchase of a $1 million *Pre*-Money Convertible. Then, Investor C comes in with $1 million of new money in the trigger financing. Post-closing of the trigger, Investor A and Investor C will each own 16.67% of the equity ($1 million of a $6 million post-closing capitalization) and the other pre-trigger equity holders will have 66.7%.

Let's complicate things a bit. What if, instead of going from Investor A's $1 Pre-Money Convertible to the trigger financing, we assume Investor B comes in with a $1 million Convertible before the $1 million new money trigger? In that case, at the close of the trigger Investors A, B, and C will each own 14.3% of Newco's equity, while the other pre-trigger equity holders will own 57%.

Before we explore the nuances, let me hammer home the point of the above examples. *The Post-Money structure shifts the dilution burden of subsequently chaining convertible rounds together, or increasing the size of trigger rounds, or even increasing incentive equity allocations from the Convertible and new money trigger investors to all of the other equity holders*.

The shift in the dilution burden should make a company that has issued a Post-Money Convertible very careful about expanding the equity pie after that issuance, whether in the form of additional Convertibles or, for that matter, employee incentives or any other equity that doesn't trigger conversion. And that, surely, is good for the Post-Money Convertible investor otherwise wary of being taken for a ride on a convertible debt merry-go-round.

Putting my investor hat on, count me in. The Post-Money Convertible is much more attractive than the Pre-Money Convertible. Not because I don't trust the entrepreneurs I invest with, but because I've been an unwilling rider on too many convertible debt merry-go-rounds.

The Complications

The above examples are illustrative of how the Post-Money Convertible structure is supposed to work. They "play by the rules" so to speak. Unfortunately, it's all too easy to come up with scenarios that get beyond the rules. Places that make for complex, problematic, and sometimes deal-killing cap tables despite the employment of the Post-Money Convertible structure.

Perhaps the simplest – and at the same time most problematic – scenario for breaking the Pre-Money Convertible rulebook is the issuance of too much pre-trigger closing equity for the math to work. Returning to our hypothetical, what if, after issuing a $1 million Pre-Money Convertible with a $4 million cap to Investor A, Newco piles on another $2 million of Convertibles and then there is a trigger financing with $1 million of new money? Well, with the $4 million post cap on the trigger financing, Investor A and the new money is locked in at 25% each, and the $2 million of additional Convertibles are locked in at 50% and now nothing is left for anyone else.

Houston, we have a problem. And you can see, I think, how it could get worse. Imagine, for example, that there was $2 million of new money in the trigger financing.

Problems – some with no solution, some with multiple solutions, and some with unexpected solutions – can be conjured up *ad nauseam* by mixing and matching Pre- and Post-Money Convertibles (at the same or different valuation caps); varying the trigger financing valuation caps; changing the size of the incentive equity pool before or at the trigger closing; etc. It doesn't take a lot of imagination to come up with head-spinning math and terms/language interpretation issues. And in my experience, entrepreneurs have a lot of imagination.

Conclusion

The Post-Money Convertible structure is a welcome new twist on the traditional convertible security structure in seed/early stage financing scenarios. Yours truly will surely look for it in deals.

Still, the Post-Money structure is no panacea for the convertible debt merry-go-round phenomenon. While it discourages them, it doesn't by itself prevent them. When used carelessly, it can lead to cap table problems as egregious and complex as those caused by reckless use of Pre-Money Convertibles.

Post-Money Convertibles put their investors in the driver's seat – but the car is not autonomous. Vigilance and a willingness to step in if an entrepreneur wanders off the straight and narrow, cap table-wise, are still essential.

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