ANGEL CAPITAL ASSOCIATION

ACA Data Insights
What We Learned From Our Data

In support of ACA's Data Insights initiative, once a month we will be sharing charts illustrating useful learnings form analyzing data on angel investing and portfolio returns.

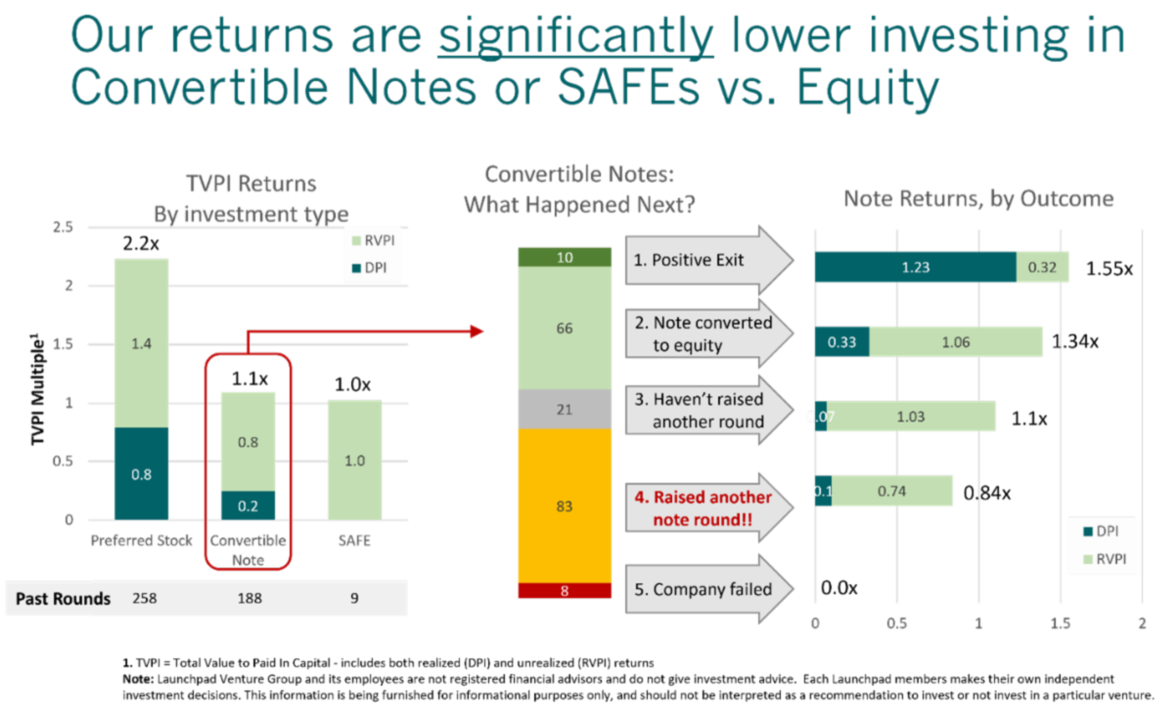
Launchpad Venture Group has always had a strong preference for investing in preferred equity rounds rather than convertible notes or SAFEs. The main reason for this is that we believe equity investment best aligns the interests of founders and investors so they can focus on building great companies together rather than worrying about the yet-to-be-determined conversion terms of debt-based investments. (The tax implications of convertible notes are another reason to prefer equity, which we can save for a future post)

Given the increasing popularity of notes and SAFEs, we frequently find ourselves pushing back on founders and other investors who tout the "speed and simplicity" of these funding tools.

However, we wondered if our preferences were grounded in performance. **At the end of the day as investors we are interested in the returns from our investments.** So, we turned to Launchpad's 20 years of investment returns data to determine what our actual returns have been from investing in equity versus convertible notes and SAFEs. To do this, we looked at 484 individual investment rounds that the group has made using Total Value to Paid-in-Capital (TVPI) return multiples for rounds with at least 18 months since the initial investment. This metric measures the current value of the investment (both realized and unrealized) as a multiple of the cash invested.

To get a clear picture of round-level returns, we needed to link back the ultimate payout from a company to the actual round where capital was invested. For example, if we invested in a convertible note round that later converted into equity as part of a subsequent fundraising, and then paid a return over two separate milestone escrow payments, we needed to determine what portion of each escrow payment came from shares converted in from the note into equity in order to determine that note's ultimate return.

The analysis results are summarized in the chart below.



Even though we prefer equity investments, we were shocked to see how much lower our returns have been from investing in convertible notes versus equity. Our TVPI multiple on convertible notes and SAFEs is half what it is for preferred equity, and this difference is sustained over 258 rounds of equity investment and 188 rounds of investments in convertible notes.

While we admittedly view SAFE notes as a cancer of the investing world and thus have little experience with them compared to some investors, there is no reason to believe their returns fare better than convertible notes, since they strip out what few remaining investor protections notes offer.

The result was surprising enough that we felt compelled to dig deeper to understand what was driving such a low average return for convertibles. We looked at what happened next after the company raised its convertible note, and what the ultimate returns were for each outcome category:

1. **Positive Exit** – For roughly 5% of note rounds, this was the last round of financing and the company successfully exited without needing to raise additional funding. This is a best-case scenario where notes were used as a bride to an exit, and the investors received a 1.55x return on their investment. While a positive return, it is worth noting that the return is still lower than the average equity returns of 2.2x because noteholders only receive the benefit of their discount or cap at the time of exit rather than growth of equity value.

2. **Note Converted to Equity** – Roughly 35% of convertible notes behave the way they are supposed to and convert into equity at the next fundraising round. The average 1.3x returns in this outcome reflect the benefits of a note discount or cap, but are still below average equity returns.

3. **Not Yet Raised Another Round** – About 11% of rounds are recent enough that the company hasn't yet raised another round of financing, but the company is still in flight. These notes are being carried at their original face value of 1x investment, and the jury is still out.

4. **Raised Another Note Round** – The big surprise here is that a shocking **44%** of note rounds were subsequently followed by another note round. These serial-note rounds absolutely kill investor returns by delaying a conversion to equity that can grow in value with the company over time, and postponing the start of the section 1202 clock to benefit from tax incentives for risky investment. Investors in these

rounds are effectively receiving debt-level returns for equity-level risk taking. Furthermore, companies that raise capital through a drip of note rounds are often under-funded and struggle to make the confident investments needed to reach “escape velocity.” Rounds in this category only returned 84 cents on the dollar, on average.

5. **Company Failed** – 4% of our note rounds were the last investment before a company failed, and they returned nothing. Companies fail as a normal part of early-stage investing; but what is different about unconverted note rounds is that in the event of failure the note typically has zero residual value, unlike equity investments that can often salvage a portion of the invested capital as the company winds down.

THE TAKEAWAY

Given these insights, it appears that our skepticism of convertible note rounds is well-justified. Furthermore, while it is impossible to know at the time of investment what a company’s next round of fundraising will be, we plan to give extra scrutiny to companies that look to be embarking on a campaign of serial note fundraising. **The expected returns just aren’t worth the headache.**

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