REVENUE BASED FINANCING

ROUND 2 CAPITAL | FEBRUARY 2020

WHAT IS IT?

Revenue-based financing (RBF) is a simple type of funding in which a company receives a capital investment in exchange for a share in its future revenue until a pre-defined absolute amount - the cap - is repaid. As the funding capacity is linked to the revenues that are generated, the investment can easily be increased step-by-step as the borrower's revenues grow over time.

The capital the company receives is expected to be invested in the future growth of the business, e.g. through hiring additional employees, creating or scaling a product, or sales and marketing initiatives. The RBF provider will expect the company receiving investment to have a growth plan that reflects how the money will be spent and what the expected impact on growth will be.

HOW DOES IT WORK?

A company receives an up-front or phased capital investment, which is repaid as a percentage of monthly revenue. This means that the amount repaid will fluctuate depending on the company's monthly performance. As the repayments in revenue-based finance are tied to monthly revenue, they naturally adapt to cash flows, going up when revenues are strong and down when revenues are weak. The repayment terms are agreed in advance. There is usually a cap on repayment at a multiple of the initial investment.

WHAT ARE THE BENEFITS VS OTHER FINANCING OPTIONS?

Under the right conditions, revenue-based financing can replace the need for traditional financing alternatives like bank loans or venture capital.

RBF financing is secured relatively quickly in comparison to bank or VC funding, as there is less due diligence required, no need to negotiate a valuation, and no changes to the governance structure necessary. Most RBF providers can provide financing in between 3 weeks and 3 months. The personal risks associated with RBF are also reduced compared to either of the more traditional financing options, as no personal guarantees or dilution of ownership are required.

To secure a bank loan, the bank will require tangible assets as a security. This poses a particularly difficult problem for tech-driven companies whose value derives from intangibles such as intellectual property in the form of software.

The monthly repayment structure of a revenue-based loan means that investors can be repaid back fully out of cash flow. The faster the business grows, the faster the investment capital is repaid and the better the return will be for the investor. For this reason, the company's interests will be fully aligned with that of the RBF provider for the duration of the investment period.

Additionally, an exit is not needed to repay revenue-based financing. This is important because the owners cannot be forced to exit at a moment that is disadvantageous from a valuation point of view and owners and will retain the full incentive to grow the value of the business.

While the cost of RBF typically is lower than a bank loan initially, as revenue grows the cost of financing also grows. In total the cost of RBF typically is higher than a bank loan but cheaper than VC financing. If the business is growing fast, RBF is particularly favorable compared to VC financing as the cost of diluting ownership of the business becomes very high.

Revenue-based financing can be used to finance the company through different growth stages by gradually increasing the investment amount. Under favorable circumstances this can even be done without increasing the revenue share paid to the investor. An increase of the financing amount typically requires approval by the investor but can be granted as an option for the entrepreneur to decide.

Venture capitalists often desire to exert control over the company, usually by requiring a seat on the board. They may also demand the adoption of aggressive growth strategies to ensure the company achieves their return aspirations, which can be as high as 5x or more in 10 years. VCs may also have requirements regarding the corporate structure for tax and other purposes. For an entrepreneur who wants to keep control of the company, revenue-based financing may therefore be more attractive as it does not lead to dilution of ownership or control.

WHAT ARE THE POTENTIAL DRAWBACKS?

As with all financing options, there are aspects to revenue-based financing which may not suit every company. Since repayment of the loan is based on revenues, the company needs to have a high gross margin. Manufacturing companies needing lots of working capital to grow sales and trading companies with low gross margins are usually less suitable for RBF.

In addition, as the funding is related to the company's revenue the capital amount that RBF providers can invest in businesses is limited, usually a quarter to a third of the annual revenue. See how revenue-based financing compares to alternative financing alternatives:

	Banks	Round2 Revenue-based financing	Venture Capital
Target companies	All companies with collateral	Fast-growing businesses (gazelles) with functioning business models	Companies with disruptive and/or exceptional business models requiring high up-front investments and a sustained period of cash-burn
Control	• Personal guarantees • Over 100% collateralized • Inflexible covenants • Share pledge / Conversion rights	• Non-financial covenants on strategy and business decisions that require approval • Partly collateralized	• Advisory board seat • Protective provisions • Drag-along rights
Dilution	None	None	Substantial
Flexibility/Leverage	• Inflexible fixed payments • High financial leverage risk	• Flexible payments linked to revenue • Low financial leverage risk	• Highly flexible • No payments • No financial leverage risk
Alignment of Interests	None	Investor and entrepreneur interest strictly aligned on revenue growth at all times	• Growth and exit at all costs • Possible goal mismatch
Exit Strategy	Not necessary	Not necessary, but welcome	Required
Cost of Capital	Low	Moderate, depending on business success	High, up to 10-20 times the investment amount
Transaction Process	Bureaucratic and slow	Simple, standardised and fast	Complicated and time-consuming

WHAT IS THE IDEAL COMPANY PROFILE TO RECEIVE RBF?

Based on the benefits and drawbacks of RBF described above, to make the most of RBF as a financing option, the company should be:

- Asset light and fast-growing: The company does not have the collateral needed to secure a traditional bank loan and has an innovative and/or disruptive business model. Even if not growing at the pace needed to be of interest to a VC firm, the business proposition must be scalable and already profitable or on the path to profitability (high gross margins).

- Predictable and/or recurring monthly revenue: The business model should steadily be generating revenue in a predictable manner (e.g. from subscriptions) which would allow an RBF provider to accurately forecast the financial performance in order to offer suitable repayment terms.

WHAT DOES THE RBF LANDSCAPE LOOK LIKE?

Revenue-based financing is in itself not a new form of financing. Historically, film/media projects, natural resource exploration projects, pharma development, and hospitality projects, among other ventures, are financed using royalties or monthly revenue streams. The US has several established RBF providers, either concentrated on a geographic region, or operating nationally. Due to the growing numbers of small and innovative companies in Europe, there is a growing interest in RBF as a financing option in Europe as well.

According to statistics provided by the European Central Bank, over 50,000 Small and Medium-Sized Enterprises (SMEs) in German-speaking Europe and Sweden are planning for a growth of more than 20% annually and are actively looking for growth financing. Some of these companies, particularly asset light service-oriented companies, experience a large supply gap in the market.

For structural reasons, banks do not have the right products nor the risk appetite to serve this market. Equity financing is typically not available or less suitable, as successful entrepreneurs strive to avoid loss of ownership control and dilution. The RBF investment approach capitalizes on this market opportunity by offering growth capital in the form of revenue-based loans, a flexible product that is better suited to the needs of the target market and which generates an attractive risk-return profile to investors.

WHAT DOES THE FUTURE OF RBF LOOK LIKE?

Technology and evolving customer needs have changed the way companies are started and run. The rise of the "as-a-service" business model, for example, has paved the way for intangible assets to create immense value for companies. However, our methods of financing innovative companies have not kept pace. Therefore, there is growing interest in revenue-based financing as a viable and more suitable alternative to traditional investment sources for innovative companies in the scale-up phase.

As the availability of revenue-based financing grows, providers of RBF will expand offerings to include more support beyond financial for growing companies. Angel investors and venture capital firms already do this by leveraging their extensive networks to connect entrepreneurs with industry experts and help entrepreneurs on the path to a trade sale or IPO.

In the RBF sphere, Round2 Capital Partners have created Round2 Labs, a program designed for entrepreneurs with established companies who plan to scale up their businesses. Programs such as these provide training by experts in their fields to support growth plans across different business verticals, such as strategy, finance, marketing and HR.

Revenue-based financing is growing as an alternative to traditional methods of financing companies. Especially well-suited to innovative and fast-growing businesses, RBF can help entrepreneurs scale their companies without diluting their ownership and without providing personal collateral, which are the typical drawbacks of venture capital investment and traditional bank financing.

WWW.ROUND2CAP.COM