REVENUE FINANCING

BIG ADVANTAGES FOR RAISING CAPITAL

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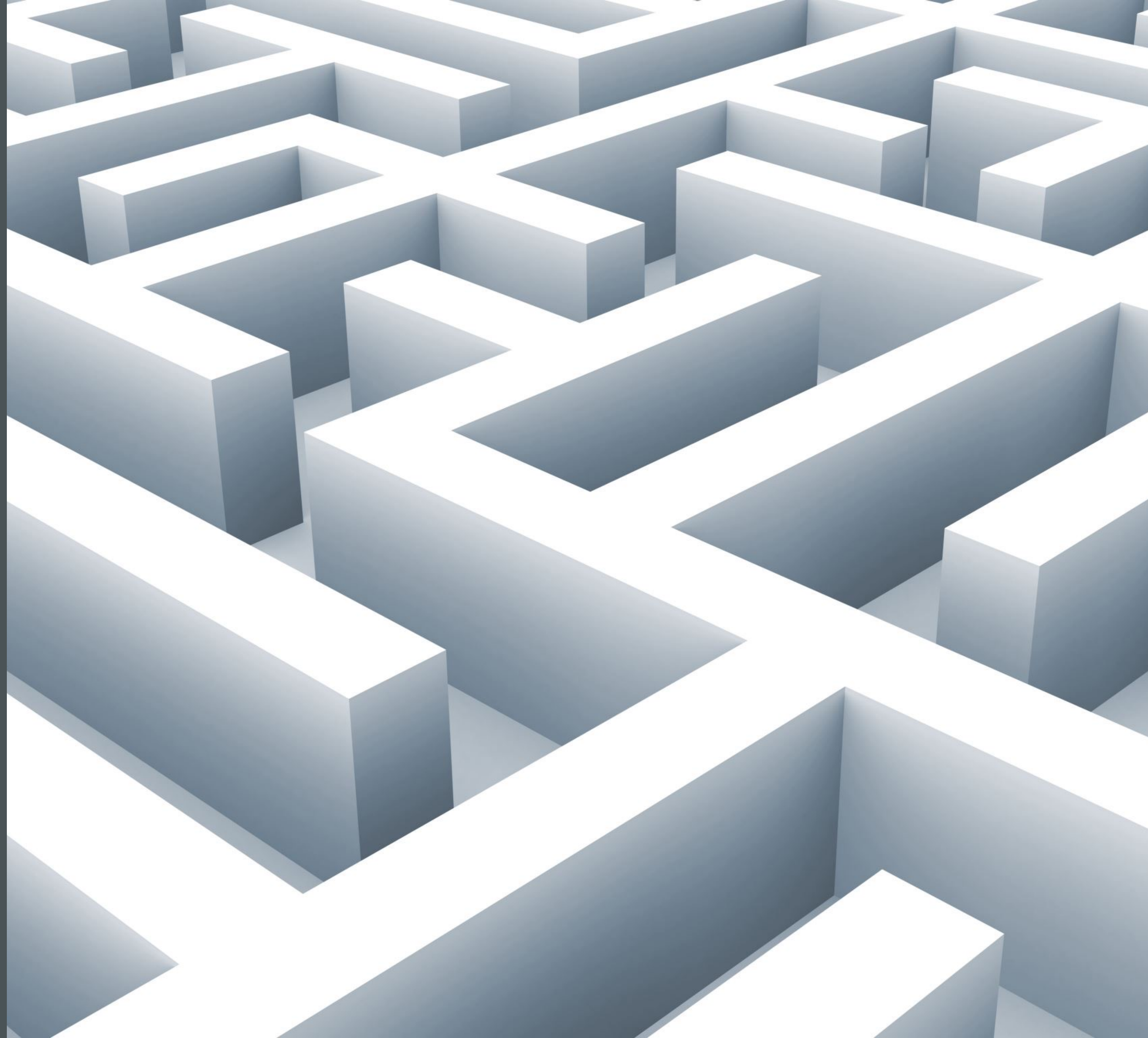

PRESENTER QUALIFICATIONS

- 12 Revenue Financed Investments
- 50+ Equity & Mezzanine Investments
- 3 Prior Funds, on my 4th

- Transatlantic M&A: Downer & Co. Boston/Paris
- Equifax Research - President
- Arthur D. Little – Transatlantic Consulting
- General Electric – MMP Program
- Clarkson University; Dartmouth/Tuck MBA

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- **Equity** – Dilutive at a set Valuation Today
  - But No Payments
- **Safe Note** – Conversion Price Uncertain
  - But Less Dilutive than Equity
- **Sub-debt** – May be Amortizing & carries warrants
  - Might be Partially Equity
- **Crowd Funding** – Getting Lots of Attention
  - Regulatory Issues and You Have to Source Most of the Investors
- **Revenue Financing** – Highly Flexible
  - But the Least Familiar Form of Financing

CALCULATING THE % OF REVENUE

1. Debt Plus Percentage of Revenue
   - 5-year Amortizing Loan With Interest of 6% to 11%
   - Typically, ½% to 6% of Revenue

2. Pure Percentage Revenue Financing
   - All Repayment of Loan Occurs through % of Revenue Paid
   - Typically, 2% to 8%
   - The % is higher as there is no Repayment of Principal and no interest.
   - Therefore, the Total Return is Entirely based on % of Revenue.

KEY FACTORS AFFECTING THE COST OF FINANCING

The Term of the Financing

1. Ranges from 3-10 Years (or perpetuity)
   - % of Revenue Higher with Shorter Term
   - Monthly Amortization, if any, is Higher with Shorter Term
   - The Forecast and growth rate projected
   - Stage of the Company
   - The Industry
   - Likelihood of an Exit and Exit Multiples
   - And the Return sought by the Investor

It's Very Formulaic

WHAT TERM?

THIS CAN VARY WIDELY

- Five Years is Common
- It Can End when Multiple of Investment is Paid to the Investor, i.e., 2x, 3x, or 4x
- It Can Terminate through Prepayment that Yields an Agreed upon IRR to the Investor
- Or it Converts into Equity when Triggered by the Next Investment

IT'S COMPLICATED!

- The Structure is Usually Dictated by the Investor Based on
  - Stage of Company
  - Perceived Risk
  - Anticipated Growth
- Our Last Fund invested in <u>profitable</u> Companies:
  - 5-year amortizing debt, plus
  - 1/2 to 1% of Revenue
  - Floor on IRR if Company wanted to prepay and end the Royalty
  - No Warrants, No Equity
    - *With One Exception . . .* *Example Follows*

EXAMPLE 1: EARLY-STAGE COMPANY

- Company had Previously been Funded through Grants
- Had Limited History: less than $1M/year Sales
- Had a Pipeline Approaching $5M
- Very Little Investment to Date by Founders and No Outside Investors
  - Which Put Our Debt at Risk as there was no Equity
  - We gave the Company 3 months to Raise $300,000 Equity after which we would Receive Warrants for the Additional Risk
- Company has Done Well Since Funding

EARLY-STAGE COMPANIES ARE THE MOST CHALLENGING

SO, WE DEVELOPED A VARIANT

- We Structured as a Debt + Revenue Security
    - Non-Amortizing 5-year Balloon Note
    - Interest Payable Monthly at 3-8%
    - Plus 3-6% of Revenue Above Base Year
    - Might Include Warrant Coverage on Debt if Forecasted Return is Insufficient
- Revenue Security is Convertible into Equity When:
  - *Forced Conversion, i.e., Sale of Company or Next Funding Round*
    - We Must Convert on Same Terms
  - *Voluntary Conversion, Initiated by Us:*
    - Valuation and Terms are Negotiated, Or
    - Two Outside Appraisals Obtained & Averaged
- Goal: Our Equity, After Converted + Warrants, Should Approximate The Company's Valuation Goal Today
    - But Since they Haven't Attracted Equity Due to Perceived Risk, our Revenue Security Solves That Problem

EXAMPLE 2: VARIANT FOR EARLY STAGE COMPANIES

- Company is doing $300,000/year, Sales Affected by COVID
- On Cusp Of High Growth with Two Product Introductions set for mid-late 2021, with impact in 2022
- Capital Raised thus far: $10M
- Valuation sought of $22M Whereas We Think it is $15M
- Structured a $2M Investment as 5-year non-amortizing Debt at Low Interest Rate plus 5% of Sales
  - Forced Conversion automatic on the Next Round if led by an Investment of $3M+, Converts on Same Terms as the Investment
  - Voluntary Conversion on Negotiated Terms *OR* At The Average of two Independent Appraisals
- Plus Warrants Exercisable into 5% of Company at a Discounted Exercise Price
- The Investment is modeled to probably Convert at a $22M Valuation Which is What They'd like today but Can't Raise from an Institutional Investor Because of the Perceived Risk.

Example of Financing

Below is an Example Excerpted from a Financial Model Built to Calculate the Returns and the Metrics For a $2M Investment

Base Revenue when Royalty Begins	**$1,000,000**				
Royalty[3]	**5%**	based on a	**$2,000,000**	Loan	
If the Loan Amount is	**$2,000,000**	the	royalty =	**5.0%**	which is applied throughout this model
Target Return:[4]	**28%**				
Interest=	**5%**	*Payable Qtrly*			

Valuation as a Multiple of EBITDA				**Valuation as a Multiple of Revenue for High Growth Companies**		
Valuation of Company	**7**	x EBITDA	or	**5**	x Revenue for a high growth company	
				which equals.	###########	at the end of year 2
Valuation of Company Today[5]	**$15,000,000**			or	###########	at the end of year 3

NOTES:

[3] **Royalty:** If the Loan is less or more than $2M, the Royalty % increases or decreases proportionately. Note that in thix example, the Royalty and the interest on debt are eliminated when the debt is converted into equity at the end of Year 3

[4] **The Target Return** is the Minimum Annual Yield in years 1 and 2 when royalty income is low. If the Target Return is missed in Year 1 or 2, the deficit is carried forward to Year 3 and is added to the $2M Principle if and when it is converted.

[5] **Strategic Valuations** are higher than Financial Valuations due to other benefits that strategic Investors receive. Also a Lower Valuation is justified due to underperformance during 2020.
Also, due to Covid-19, Valuations have been 25-30% lower since April, 2020 than pre-Covid.

Example of Financing (Cont.) Showing the Potential Returns as a Multiple of Investment

Return calculation. with Conv. of Debt and Exer. of Warrants

YEAR	Warrants Exercisable into $X of Stock	Valuation of Co. as Multiple of EBITDA in Years 2-5	Ownership Exercised Warrants Represent	Exercise Price When Warrants are Exercised	Appreciated Value of Shares After Warrants Exercised less Exer. Price	Investment Basis: (Warrant Exercise Price + Outstanding $ Debt Converted)	% Equity After Converting Debt in 3rd year	Value of Converted Debt if conv. in 3rd Year at yr 3 Valuation	Cumulative Royalty Plus Interest thru Year 3 when both stop	Minimum Return on Investment = Target IRR[6]	Return as a Multiple of Investment[7]
Base Yr 2020	$1,500,000	*$15,000,000*	10.0%	$450,000		*Warrants Exercised & Debt Converted in Year 3*			*Royalty + Interest Cease after Year. 3*	*28%*	
1		$15,000,000			$0	$2,820,000		$0	$190,000	$2,560,000	1.3
2		$11,567,500			$0	$2,955,000		$0	$615,000	$3,120,000	1.6
3		$33,348,000			**$2,884,800**	$2,765,000	6.9%	**$2,315,000**	**$1,365,000**	$3,680,000	2.4
4		$71,400,000			$7,140,000	$2,765,000		$4,956,549	$1,365,000		4.9
5		$130,928,000			$12,642,800	$2,765,000		$9,088,950	$1,365,000		8.4

NOTES:

[6] **Return as a Multiple of Investment:** Column L calculates the minimum return required or target return.

[7] **Return as a Multiple of Investment** sums the Value of the Converted debt PLUS exercised warrants PLUS interest and royalty paid DIVIDED by the investment basis

- **Many Companies Paid the Note Early From the Sale of the Company**
  - This Ended the Revenue Payments For those Companies
  - Yielded a Good Return to the Fund
- **Some Refinanced the Notes**
  - Using Lower Cost Debt after 3-4 years based on their improved position as a Result of Our Financing
- **Two Underperformed and Closed**
  - One provided a PG which covered most of the Note
    - PG's are Rarely Required (only in this instance)
  - The Second Company's Founder Deceased and Life Insurance Covered Part of the Note
- **Overall Experience**
  - Revenue Financing is an Affordable Means to an End for the Company, and is a Safer Investment for the Investor

ADDITIONAL BENEFITS OF REVENUE FINANCING

- The Amount Paid to the Lender in Excess of the Original Loan is **Fully Tax Deductible**
- The Proceeds Show as Cash on the Asset Side of the Balance Sheet, but the Loan may not have a Corresponding Liability as with Senior or Subordinated Debt as the Repayment of the Principal Amount may be Contingent upon Revenue Being generated.
  - The Net Effect is to Increase the Net Worth of the Company
  - The Financing Must Still be Footnoted However

OTHER USES FOR REVENUE FUNDING

- **Small Publicly-Held Companies Trading at a Low Price**
  - This Doesn't have to be Tied to Currently Traded Price
  - Makes it Easier to Raise Capital
  - Bring it Private in a Tender Offer, Gives the Current Investors a 'Fair Deal', Exchanging Equity for a Revenue Debt Security
- **Management Buyouts**
  - Gives Selling Shareholders Some Sharing of the Upside
  - Plus the Security of a Debt Position
- **ESOP's**
  - A Source of Non-Equity Funding which ESOP's Like
- **Family-Owned Companies**
  - Again, Can be Structured without Warrants or Equity

IMPACT ON EXIT VALUE

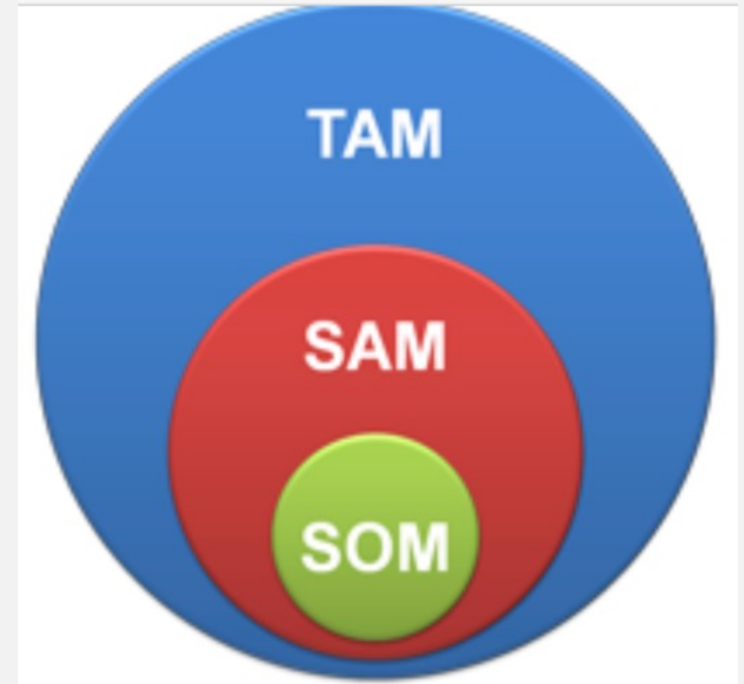
- While Revenue Financing is in Place EBITDA is Lower
- *However* . . .
- The Numbers will be Recast by a Prospective Buyer
  - To Show Operation without a Revenue % as an Expense, Post Exit, Hence a Higher EBITDA
  - Thus, the Value based on Multiple of EBITDA Is High

WHAT STEPS SHOULD THE PROSPECTIVE BORROWER TAKE

- Regardless of your Stage, Prepare a Forecast
  - Be Realistic, Show Reasonable Growth
    - Do Two Scenarios:
      - Base Case & Aggressive Case
  - Back it up with a **Sales Pipeline**
    - Include Customer Input even if only from Prospective Customers
  - Make the Model Dynamic: Easy to run scenarios
  - Should Contain the Full Income Statement, Balance Sheet & Cash Flow . . . With supporting Sheets for Sales Pipeline, Expense Breakdown, Cost Of Goods, or Whatever is Relevant to your Business; List Detailed Assumptions
- 'Solve for Cash' to Support your Funding Request
- Make it User Friendly and Easy to Run

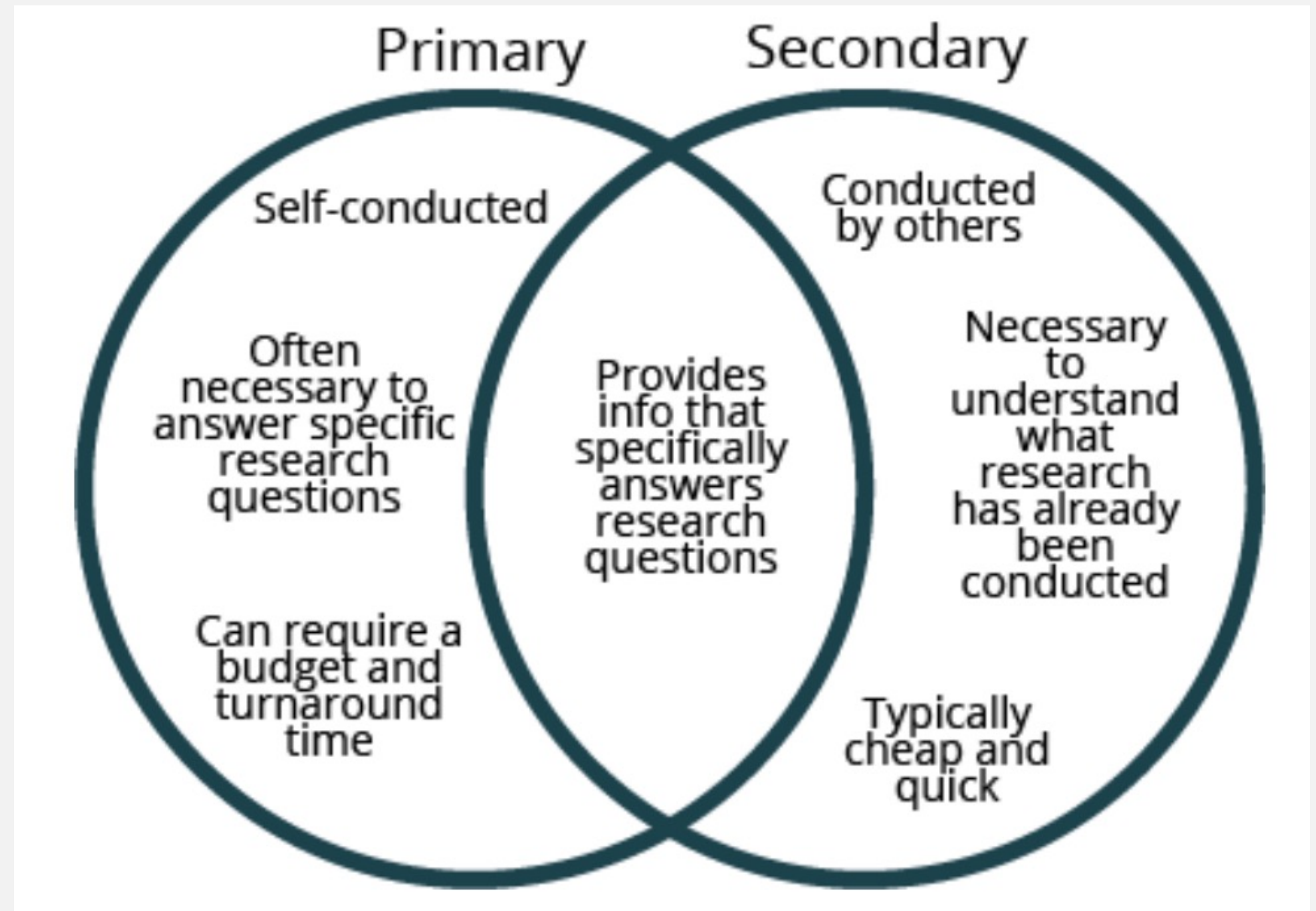
JUSTIFY YOUR FORECAST

- Show Realistic Market Estimates and Sales Forecasts
  - Total Available Market (TAM)
    - Typically refers to the *revenue opportunity of an Industry.*
    - *Gathered through Secondary Research from Studies, etc.*
  - Serviceable Addressable Market (SAM)
    - That portion of the TAM that is specific to your product or service and within your reach
  - Serviceable Obtainable or Attainable Market (SOM)
    - That portion of the SAM that you can promptly capture
- Investors will focus on SAM and SOM
- **You will want to conduct *Primary Research* To confirm the demand**



CONDUCT PRIMARY RESEARCH

- **This will Differentiate You**
  - Interview Prospective Customers (Preselling Oppty)
  - Do Many Interviews Yourself
  - Offer an Incentive Report
  - Ask About Competition
  - Capture Quotes & Anecdotes & Add to your Slide deck



SOURCES OF REVENUE FINANCING

- Used to be Two Funds, One in California & Ours in Boston, That Focused on Lower Market Deals
  - Although Angel Investors Have Used it
  - Others Focus only Large Oil and Pharma Deals or on Theatrical Productions
- New Ones have Emerged, One in TX, and One in WA
- Plus Others that offering Quick Decision ‘Merchant Cash Advance-Type’ Financing
  - Be Careful of these – Speed to Fund may Equal Expensive Financing

SEEK TRANSPARENCY IN THE PROVIDER

- Equity Financing is more 'black box' and Rarely does a Provider Disclose their Assumptions
- Since Revenue Financing is so Formulaic
  - A Provider may be More Willing to Share their Assumptions and Perhaps their Financial Model

- I'd be happy to Answer any questions now.

IF YOU HAVE ADDITIONAL QUESTIONS OR WOULD LIKE TO RECEIVE A COPY OF THIS DECK

EMAIL ME

AND IF YOU'D LIKE TO DISCUSS REVENUE FINANCING (AND OTHER TYPES), CONTACT ME AND WE COULD SET UP A 20-30 MINUTE ZOOM CALL

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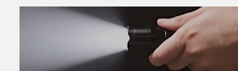

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